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VIA E-MAIL, FAX AND OVERNIGHT MAIL

August 22, 2007

Ms. Elizabeth O'Donnell
Executive Director
Kentucky Public Service Commission
211 Sower Boulevard
Frankfort, KY 40602

Re: Surcharge Interim Options

Dear Ms. O'Donnell:

Duke Energy Kentucky, Inc. ("DE-Kentucky") provides the following comments regarding the matters discussed at the Commission's August 16, 2007 informal conference to consider the implications of the Franklin Circuit Court's August 1, 2007 Opinion and Order in Civil Action No. 06-CI-269.

Mr. David Samford, the Commission's General Counsel, stated that until the Kentucky Court of Appeals issues a stay of the Franklin Circuit Court's Opinion and Order, the Commission probably would not approve future surcharge adjustments unless the surcharge is expressly authorized by a specific statute. Mr. Samford presented three options the Commission could include in its request for a stay from the Court of Appeals:

1. Allow the Commission to continue approving surcharge adjustments, and require the utilities to collect surcharge revenues subject to refund, and maintain records that would allow the utilities to identify the specific customers to whom any refunds would be paid;

2. Allow the Commission to continue approving surcharge adjustments, and require the utilities to collect surcharge revenues subject to refund, but not require utilities to maintain records that would allow the utilities to identify the specific customers to whom the refunds would be paid. Instead, any refunds would be paid to existing customers at the time the refunds are ordered; or

3. Allow the Commission to continue approving surcharge adjustments, but surcharge revenues collected would not be subject to refund.

The Commission invited stakeholders to comment on which option they support, and the likely rate impacts. The Commission also encouraged utilities to comment on the topics discussed below.

As an initial matter, DE-Kentucky thanks the Commission for its efforts to put stakeholders on notice of the significant impacts of the Franklin Circuit Court Opinion and Order. DE-Kentucky also thanks the Commission for the opportunity to address these matters at the August 16, 2007 informal conference and in the following comments.

Surcharge Interim Options

DE-Kentucky prefers that the Commission adopt Option #2 above because this will provide the Commission with a better opportunity to obtain a stay from the Court of Appeals, and this option preserves the status quo between utilities and customers, without requiring utilities to do burdensome recordkeeping.

When the Commission requests a stay from the Court of Appeals, the Court will weigh the equities between the utilities and customers by evaluating the likelihood that the Commission will prevail on the merits of the appeal; the harm that the utilities would suffer if a stay is denied; and whether a stay would reasonably preserve the status quo between utilities and customers pending a decision on the merits of the appeal.[1]

Option #2 preserves the status quo between utilities and customers by requiring utilities to collect surcharge revenues subject to refund. Any refund resulting from the outcome would be paid to existing customers at the time a refund is ordered. Although this would not provide refunds of the exact amounts paid to the exact customers who paid the surcharges, the appeal will likely be decided in approximately one year, and DE-Kentucky does not anticipate major turnover in its customers during this time. This option avoids the necessity of detailed recordkeeping that would be required to pay refunds to the exact customers who paid the surcharges. Smaller utilities might not be able to implement billing programs to pay refunds to the exact customers who paid the surcharges. All utilities would likely incur significant expense if required to maintain records to allow them to pay refunds to the exact customers who paid the surcharges. These costs of compliance would either be deducted from the refund or would otherwise be passed on to customers. A general refund to existing customers at the time of the refund would probably result in most customers receiving refunds very close to the surcharge amounts they paid, and would avoid the complex and costly recordkeeping necessary to pay exact refund amounts.

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1 *Maupin v. Stansury,* 575 S.W.2d 695 (Ky. App. 1978).

Rate Impacts

DE-Kentucky is unable to ascertain the exact rate impacts from collecting surcharge revenues subject to refund because DE-Kentucky is unable to predict how long such a refund obligation would continue, and how much fuel costs, gas costs and other costs might increase or decrease from the amounts currently reflected in the existing surcharge rates.

As a general matter, the most significant surcharges are the Fuel Adjustment Clause ("FAC") and the Gas Cost Adjustment ("GCA") surcharges, which allow utilities to recover fuel costs and gas costs, respectively. DE-Kentucky's fuel costs were frozen prior to January 1, 2007. DE-Kentucky recently concluded an electric base rate case which re-set the base rate fuel cost. As a result, approximately 98% of DE-Kentucky's electric revenues are currently recovered through DE-Kentucky's base rates. Over time, however, DE-Kentucky expects that its fuel costs will likely increase, such that its base rates will reflect a smaller proportion of fuel costs. DE-Kentucky collects approximately two-thirds of its gas revenues through the Gas Cost Adjustment rider. Gas costs have been relatively volatile during the past few years. If gas costs increase above the level currently reflected in the GCA rider, this could result in a significant hardship for DE-Kentucky. If gas costs decrease below the level currently reflected in the GCA rider, this could result in a hardship for customers because they would be over-paying for gas costs. For the past several years, it has been state policy to allow gas and electric companies to recover gas commodity costs and fuel costs on a dollar-for-dollar basis through surcharges. This sound policy benefits utilities and customers because it matches the fuel and gas commodity rates to costs and allows utilities to recover the costs in a timely manner. This helps the utilities maintain their financial strength, which tends to lower their cost of capital, which ultimately benefits customers in the form of lower rates.

The following is a summary of DE-Kentucky's surcharge revenues in 2006 and 2007:

	Twelve Months Ended December 31, 2006		Seven Months Ended July 31, 2007	
Gas				
GCA	$	95,782,483	$	70,411,968
Accelerated Main Replacement Program	$	680	$	25
Merger Savings Credit Rider-Gas	$	(66,160)	$	(126,979)
Demand Side Management	$	1,543,127	$	477,804
Base Revenue	$	41,586,649	$	30,095,310
Total Billed Revenue	$	138,846,779	$	100,858,128
		70%		70%
Electric				
FAC	$	(9,716,617)	$	6,270,008
Off-System Sales Profit Sharing Mechanism	$	(1,380,034)	$	(3,125,835)
Merger Savings Credit Rider-Electric	$	(1,278,844)	$	(1,180,011)
Demand Side Management	$	1,630,702	$	1,318,146
Base Fuel	$	74,029,482	$	49,531,197
Base Revenue	$	*167,087,248*	$	*117,124,245*
Total Billed Revenue	$	230,371,937	$	169,937,750
		-5%		2%
Summary				
Total Riders	$	*86,515,337*	$	*74,045,126*
Total Revenue	$	369,218,716	$	270,795,878
% Riders		23%		27%

List of Surcharges/Surcredits Implicated by the Opinion and Order

A list of DE-Kentucky's surcharges is set forth in the table above. The Commission is authorized to approve these surcharges under its general ratemaking authority. The only statutes that expressly authorize these surcharges are KRS 278.509 (for gas main replacement surcharges, which the Franklin Circuit Court ruled unconstitutional) and KRS 278.285 (demand side management).

Total Dollar Amount and Percentage of Annual Revenue Collected from Surcharges

This information is presented in the table above.

Estimated Compliance Costs if Costs Can Only be Adjusted by General Rate Cases

If costs could be adjusted only through general rate cases, DE-Kentucky anticipates that it might need to hire additional personnel to process the continuous stream of general rate cases that would result. Additionally, DE-Kentucky would need to pay outside consultants to assist in presenting these rate cases, to address cost of equity and depreciation rates. DE-Kentucky might also be required to hire outside counsel to assist with these cases. Based on recent experience with a 2005 gas rate case and a 2006 electric rate case, DE-Kentucky estimates its cost for outside consultants for presenting a general rate case at approximately $300,000 per case. DE-Kentucky would probably incur an additional cost of approximately $100,000 per case for outside counsel.

Potential Credit Market Impacts and Corporate Securities Implications

Utilities' cost of capital is determined, in part, on the credit ratings agencies' ratings of the quality of the utilities' debt. One factor the credit rating agencies consider in evaluating utilities' debt is the regulatory environment in the state where the utility operates. If DE-Kentucky is no longer permitted to receive surcharge adjustments, the credit rating agencies would likely determine that the quality of regulation in Kentucky is poor, and could downgrade their ratings for debt issued by DE-Kentucky. This would increase DE-Kentucky's cost of capital and would ultimately result in higher rates for customers. Depending on the Court of Appeals' ruling on a motion for stay, utilities might need to establish accounting reserves for a possible refund obligation. In addition to the potential decrease in earnings, the inherent uncertainty surrounding this issue would also increase DE-Kentucky's cost of capital, resulting in higher rates for customers.

Sincerely,

John Finnigan

John J. Finnigan, Jr.
Associate General Counsel

JJF/bjl

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